The Conceptual Structure of China's New Corporate Bankruptcy Law

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Introduction

The passage of China's new corporate bankruptcy law on 27 August 2006 stands as a landmark in the legislative history of China's reform efforts in the area of economic law[1]. In 1994 this legislation was first put onto the national legislative program in China,[2] and numerous drafts were then produced prior to the enactment of the 2006 Law by the National People's Congress of the People's Republic of China (PRC).[3] Not only has it had a lengthy legislative history[4], it was also one of the last remaining building blocks in the framework of China's economic laws and now sits beside other important new PRC economic and civil laws, such as the Contract Law, the Company Law, the Securities Law, the Anti-Monopoly Law and the Property Law.

It has long been argued that the existence of a comprehensive corporate insolvency law is a key element of any well developed market based legal system. Although the 2006 Enterprise Bankruptcy Law is not China's first bankruptcy law, with earlier regional and national laws being enacted by the People's Republic of China,[5] the new bankruptcy law brings China much closer to having a broadly based corporate bankruptcy statute than at any time previously.

The 2006 Law replaced the much more limited 1986 Enterprise Bankruptcy Law (For Trial Implementation). That earlier law had had a considerable impact upon State owned Enterprises (SOEs). As Professor Li Shuguang pointed out a few years before the passage of the 2006 Enterprise Bankruptcy Law:[6]

> Many Chinese and foreign scholars as well as members of the business community share the common misconception that there are only few enterprise bankruptcies in China. In reality, since the [1986] Bankruptcy Law came into effect in November 1988, the law has been invoked to close more than 16,000 enterprises. After a slow start, the rate of bankruptcies has accelerated rapidly, particularly in the last several years ..... Bankruptcy has not been limited to ailing state firms, but rather has applied to all types of enterprises. In 1994, only 395 of the total 1,624 bankrupt enterprises were state firms. Among the 5,396 bankruptcies in 1997, 3,060-plus were SOEs (675 in the 111 experimental cities); the rest were private, collectively owned or Sino foreign joint ventures.

[1] See further Tomasic and Wang (2006).
[2] Shi (2002), p. 46.
[3] For a discussion of an earlier version of this legislation, see Tomasic (1998).
[4] See further, Tomasic and Wang (2005).
[5] See generally, China Chapter 2 in Tomasic and Little (1997); and pp. **XXX** of this volume.
[6] Li (2004).

The spectre of large scale bankruptcy of China's indebted SOEs had been a concern for government in China and efforts were therefore made to moderate the use of the 1986 bankruptcy law; as Professor Li explained:[7]

> Aware of the problems associated with bankruptcies, the government has adopted a policy of promoting mergers over bankruptcies. This new policy accounted for the sharp decrease in the number of bankruptcies in the experimental cities in 1997 compared to 1996. While this approach may prove to be a palliative in the short term, in the long run, it raises the question of who will merge with a bankrupt SOE. In addition, in the area of SOE bankruptcies, there are further obstacles such as an imperfect legal system, excessive administrative intervention, disordered guarantee arrangements, fraudulent bankruptcies, low benefits of liquidation, a shortage of bankruptcy professionals, local protectionism, and difficulties in selling assets for cash. … Recognizing the inefficiency of this approach, which results in mere shifting of problems from one enterprise to another, I proposed in 1998 that bankruptcy be adopted as the preferred solution for insolvent SOEs. Only bankruptcy, rather than merger, can provide a complete cure. Indeed, in 2000, the central government began a new policy of 'more bankruptcies, less mergers'.

Of course, it needs to be said that China's Enterprise Bankruptcy Law of 2006 has yet to be fully implemented as its practical meaning will depend upon the availability of a range of qualified insolvency practitioners and experienced insolvency law judges. This partly explains why in 2007, only 3817 bankruptcy cases were accepted by PRC courts.[8] The challenges facing the implementation of this new law will inevitably define the nature and impact of this law.

Whilst the new legislation does not deal with personal bankruptcy, its focus is upon enterprise legal persons, whether incorporated or not. The Law provides for a number of important remedies in addition to liquidation, such as court sanctioned corporate reorganisations and compromises with creditors. In so doing, it brings China closer to the more debtor friendly corporate rescue philosophies found in other insolvency laws; it also comes closer to the emerging global norms that are applicable to corporate insolvencies.[9] But it also seeks to ensure that the interests of creditors, particularly employees of the debtor enterprise, are fairly treated. The new law has provided the mechanism of corporate rescue or reorganisation as an alternative to liquidation and in so doing has provided greater flexibility in the administration of corporate insolvencies.

Inevitably, like all laws, this new Law should be understood by reference to the social context in which it has emerged. Not surprisingly, there will be 'Chinese characteristics' in this law, just as China's form of capitalism has been described as having Chinese characteristics.[10] This is in keeping with broader debates concerning the 'varieties of capitalism' that can be identified.[11] China's culture and political processes will have an

[7] Li, (2004) supra
[8] Quoted by Tang (2006).
[9] See further, Tomasic (2007).
[10] Huang (2008).
[11] See further, Hall and Soskice (2001).

important effect on the shape of its markets as has also occurred in other parts of the world.[12] This is related to the argument that pre-existing legal patterns in China will affect how its new bankruptcy law operates; this argument emphasises the importance of 'path dependency' in the development of laws in different nations.[13] It is clear that many cultural factors have shaped Chinese attitudes to debt and bankruptcy.[14] A large body of scholarly writing on enterprise reform and corporate governance in China has now emerged; however, we have yet to see a similar body of writing in regard to China's insolvency laws. This is attributable to the fact that wider official concern about the importance of this area only began to be felt in the decade after the Asian financial crisis in the late 1990s.

The Evolution of International Insolvency Law Principles

American and European authors have written at length on the principles underlying corporate insolvency laws.[15] Each has produced their own lists of key principles, and these lists have tended to share a number of common features. For example, ten broad insolvency principles were identified by the influential English legal scholar, Professor Roy Goode, in his *Principles of Corporate Insolvency Law*, in the following terms:[16]

1. Corporate insolvency law recognises rights accrued under the general law prior to liquidation;
2. Only the assets of the debtor company are to be available for distribution to creditors;
3. Security interests as well as other real rights that were created prior to insolvency proceedings should not be affected by the liquidation;
4. The liquidator gains possession of the company's assets subject to all limitations and defences;
5. The pursuit of personal rights against the company is converted into a right to prove for the dividend in the liquidation;
6. With the commencement of liquidation, the company ceases to be the beneficial owner of its assets (as they are held on trust for the discharge of its liabilities);
7. No creditor has any interest in any specific asset of the bankrupt company;
8. Liquidation accelerates creditors' right to payment;
9. Unsecured creditors rank pari passu;
10. Members of a company are not as such liable for its debts.

Over the last decade we have also seen the emergence of an international template or palette of measures which constitute a well developed body of insolvency laws; this has been orchestrated by various multilateral bodies, such as the World Bank and the Asian Development Bank,[17] culminating with the efforts of UNCITRAL to draft a broadly based legislative guide on insolvency law.[18] This had been preceded by regional efforts to prepare core insolvency principles or practice guides, such as has been seen in the work of the Asian

[12] See further Roe (1994).

[13] See generally in regard to path dependency literature: Gordon and Roe (2004),

[14] See further: Tomasic and Little (1997).

[15] See for example, Jackson (1986). Also see Wood (1995).

[16] Goode (2007), pp. 69-81.

[17] See further, Halliday and Carruthers (2009), Also see Carruthers and Halliday (2006), and Block-Lieb and Halliday (2004).

[18] UNCITRAL, (2005), *Legislative Guide on Insolvency Law*, available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html.

Development Bank in East Asia.[19] Other regional banks, such as the European Bank for Reconstruction and Development, have also undertaken similar efforts. However, unlike many other Asian countries, China has been more able to resist pressure from multilateral bodies seeking to impose externally derived legal models. Instead, we have seen an internal debate between domestic Chinese elites being especially important in shaping insolvency laws in China.[20]

These international efforts were reflected in debates that were occurring within China itself. These debates were to shape what is now the Enterprise Bankruptcy Law of 2006. One of the key forums in which these debates took place was the Finance and Economics Committee of the National People's Congress; this was supported by efforts of foreign aid bodies, and particularly by the German international aid body, GTZ.[21] Towards the end of the domestic debate, other Chinese institutions such as the Legislation Committee of the State Council, also played significant roles in shaping the consensus upon which the new law is now based. China's law makers were well aware of the international debates that had been underway regarding the transformation of bankruptcy laws since the early 1980s culminating with the work of the OECD and the Forum for Asian Insolvency Reform (FAIR) leading to a major international conference of FAIR held in Beijing in April 2006; this was co-sponsored by the Development Research Centre of the PRC State Council.[22] The involvement of the State Council engaged the highest levels of government in China in the domestic bankruptcy reform debate.

There have clearly been many domestic and international influences that have had an effect upon the shape of the 2006 Enterprise Bankruptcy Law. The actual meaning of this Law will of course evolve over time as efforts are made to implement its provisions. However, at this point in time, it is appropriate to seek to evaluate this new law and to assess how its provisions reflect insolvency law ideas found in other parts of the world. This may be seen as an effort to identify its key principles or assumptions. The identification of such principles or assumptions has been central to the enactment of other new corporate insolvency laws in other parts of the world and is reflected in the UNCITRAL Legislative Guide on Insolvency Laws (hereinafter 'Legislative Guide') that was approved by the United Nations in 2005.

To assist insolvency law reformers around the world, the UNCITRAL Legislative Guide set out nine key objectives of insolvency law; these were in the following terms:

1. The provision of certainty in the market to promote economic stability and growth;
2. The maximization of the value of assets ;
3. Striking a balance between liquidation and reorganization;
4. Ensuring the equitable treatment of similarly situated creditors;
5. Provision for timely, efficient and impartial resolution of the insolvency;
6. Preservation of the insolvency estate to allow equitable distribution to creditors;

[19] See for example, Harmer (2000).

[20] This may be compared with the role of local elites in law reform efforts in other transitional economies. See further, Dezalay and Garth (2002).

[21] See further: Gebhardt and Zhu (eds), (2004).

[22] For papers from these OECD sponsored meetings see further at: http://www.oecd.org/document/63/0,3343,en_2649_34845_38141887_1_1_1_1,00.html.

7. Ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information ;
8. The recognition of existing creditor rights and establishment of clear rules for ranking of priority claims ; and
9. The establishment of a framework for cross-border insolvency.

These objectives are further discussed in greater detail in the body of the Legislative Guide, and reference should be made to these discussions for a further elaboration of these principles. To varying degrees these earlier efforts to set out national, regional and global standards for insolvency law making have had an influence upon insolvency law reformers in China.[23]

This chapter will seek to identify the key principles or assumptions that are reflected in the form of the 2006 Enterprise Bankruptcy law and to contrast these with parallel ideas reflected in international standards, such as the Legislative Guide. This may serve as something of a base line against which to evaluate subsequent efforts to implement this law. What is clear from the following discussion is that China's Enterprise Bankruptcy Law in different ways seeks to achieve most, and perhaps all, of the global insolvency law objectives listed above.

The Objectives of China's Corporate Bankruptcy Law

On the eve of the passage of the new 2006 Enterprise Bankruptcy Law there was a realisation that there were serious inadequacies with the existing bankruptcy laws in China and that the time had come for a change. As Professor Li Shuguang, a member of the legislative drafting group for the Enterprise Bankruptcy Law, had pointed out:[24]

> The existing [1986] Bankruptcy Law is hard to implement. Much of its content does not adequately address the complex economic realities of China. SOE bankruptcy procedures are vague and those governing non-SOE bankruptcies are deficient. There is no legal basis for filing bankruptcy for a natural person, partnership, or corporation. Since there is no reorganization procedure for insolvent enterprises, it is difficult to determine where the responsibility of the managers of the bankrupt enterprises lies. In addition, there are conflicts and inconsistencies between the Bankruptcy Law and existing government policies.

Based upon his review of China's experience over the preceding 12 years, Professor Li went on to persuasively argue the case for a new Chinese bankruptcy law:[25]

> Some scholars argue that bankruptcy law is not suitable for the national conditions in China. Nevertheless, twelve years of practice with bankruptcy law, combined with the deepening of the SOE reform and the development of the market economy, have persuaded many Chinese of the country's need for a new bankruptcy law. Bankruptcies have become an inevitable economic reality. Recently, many scholars and entrepreneurs, particularly creditors, have advocated the replacement of the existing bankruptcy law with a new bankruptcy law that is

[23] See for example, Wang (1998).
[24] Li (2004) above.
[25] Li (2004) above.

> more suitable for the new market economy. The original bankruptcy law is out of date with current realities. First, a large number of companies not owned by the government have been established under the rules of the new market economy in the twenty years since economic reforms began. These companies expect to operate within a legal framework more suited for a market economy. Clearly, the original bankruptcy law cannot apply to these companies. Second, even for money-losing SOEs that still carry the inertia of the planned economic system, the inevitable transition to market economy has made the existing bankruptcy law inadequate.

It is clear that the 2006 Enterprise Bankruptcy Law was aimed at remedying many problems in the pre-existing Law. Of course the passage of a law will not necessarily bring about changes overnight, but its passage was an important signal suggesting that the central government was more serious about adopting new approaches to bankruptcy and market failure. However, it should not be forgotten that in the past the government itself may have been the cause of many bankruptcy problems that arose, especially in regard to SOEs. As Professor Li pointed out:[26]

> The Chinese government plays a special role in enterprise bankruptcies in China. The government's role is both dominant and multi-faceted in SOE bankruptcies. It initiates these bankruptcies, yet at the same time, is the policymaker, the leader, and the direct operator in them. The government not only controls their number, scale, and speed, but also decides what industries and trades are covered under the bankruptcy law.

The objectives or principles underlying the new Law are important statements of national policy; these can be discerned from a number of sources. The most obvious of these are the terms of the legislation itself; the legislative history of this Law may also reveal important principles and assumptions. As no living body of law is static, the interpretation of this law, especially by the Supreme People's Court, is likely to give further shape to broadly based principles found within the legislation. However, at this point in time, the focus here is limited to the legislation itself. More work will need to be undertaken at a later time on its actual implementation.

The principles underlying China's Enterprise Bankruptcy Law may be found in a number of provisions within the legislation. These principles are most evident in the 'General Provisions' found in Chapter 1 of the Law, but they are also to be found in later chapters. The General Provisions proclaim a number of general principles in a summary fashion and many of these are subsequently expanded upon in later Chapters. Thus, Article 1 provides for five broad purposes of the Law. In many ways they echo objectives found in the UNCITRAL Legislative Guide.

These new Chinese bankruptcy principles might be described as the 'Article 1 principles':

1. Providing a legal procedure for the regulation of enterprise bankruptcy;
2. Ensuring the fair settlement of claims and debts in regard to the enterprise;
3. Protecting the lawful interests of creditors;

[26] Li, (2004) above.

4. Protecting the lawful interests of debtors; and
5. Maintaining an orderly (socialist) market economy.

These are fairly conventional goals for any corporate insolvency law, but with a slight Chinese variation. Inherent within these principles is an overriding commitment to the use of legal mechanisms for the handling of corporate insolvency proceedings. To this extent, this is a conscious decision to use the rule of law, rather than administrative mechanisms for dealing with enterprise insolvency.[27]

The general principles in Article 1 of the Enterprise Bankruptcy Law are supplemented by five further principles found in Articles 2 to 6 of Chapter 1 which might be seen as flowing from these five specific objectives. These might be described as second order principles and may be termed as follows:

1. The insolvency principle
2. The rescue principle
3. The judicialisation principle
4. The extra-territoriality principle, and
5. The employee protection principle.

Each of these five second order principles found in Chapter 1 of the Law can be briefly discussed.

Insolvency principle

An insolvency test is laid down in Article 2 which is built upon inability to pay debts that are due; this test may be generally described as the *insolvency principle*. This test provides a procedural mechanism with which to commence insolvency proceedings. Further procedural rules are to be found in the Civil Procedure Law which is applied to bankruptcy cases by Article 4.

Rescue principle

The inclusion of the rescue procedure in the Law provides for some procedural flexibility, as Article 2 contemplates the use of liquidations and/or reorganisation procedures and thereby assumes that corporate rescue may be a viable alternative to liquidation; this may be described as the *rescue principle*; this is articulated more fully in Chapter 8. The rescue principle has dominated insolvency law reform since the passage of the 1978 US Bankruptcy Reform Act[28] and the 1986 UK Insolvency Act.[29] In many ways, the most distinctive feature of the new 2006 Enterprise Bankruptcy Law is its provision of a formal set of procedures for the reorganisation of companies or enterprises in distress.[30]

Judicialisation Principle

Article 3 of the Law provides for judicial oversight of enterprise bankruptcy proceedings; this suggests a rule of law approach to insolvency, although considerable reliance is placed by the courts upon the use of suitably qualified insolvency administrators to implement its rulings; this may be described as the *judicialisation principle*. Court supervision and control of

[27] In relation to progress in the development of the rule of law in China see Peerenboom (2002).
[28] See further Baird, (1993).
[29] See further, Fletcher (2009).
[30] See further, Parry and Zhang (2008).

corporate insolvency and reorganisation proceedings is not always essential, as a country may have a well developed pool of independent insolvency practitioners who may be trusted to manage reorganisations, with courts only having a residual function, as occurs with voluntary administrations in Australia.[31]

However, the absence of a tradition of insolvency administration in China means that an authoritative national institution, such as the PRC courts, must play a much greater role in such proceedings. Courts in China are assuming an increasingly important role in the handling of corporate insolvency cases as is evident from judicial statements made by various Chinese judges.[32] However, despite the improvements made in recent years in the capacities of Chinese courts,[33] criticisms have been made of their capacity to act with any degree of independence.[34] As Professor Li Shuguang has observed in regard to SOE bankruptcies:[35]

> The courts' role in SOE bankruptcies is derived from the power of the government and is thus limited in many aspects. Since the government appoints judges and allocates budgets for courts, Chinese courts are hardly independent of the government. Chinese courts are divided into four levels: the Supreme Court, High Court, Intermediate Court and Local Court. Unlike the American system, in which bankruptcy courts have exclusive jurisdiction over bankruptcy cases, there is no unified provision in China specifying which court (i.e. the court of which level) has jurisdiction over bankruptcy cases. Most of these cases are conducted by the Economic Trial Branch of Local Courts and Intermediate Courts. Absent approval by the government, courts are often hesitant to accept and hear bankruptcy cases. Judges are supposed to apply the existing bankruptcy law when handling these cases. They are, however, restrained by bankruptcy policies of governments of different levels, which at times conflict with the bankruptcy law. Moreover, the majority of Chinese judges are not experienced in dealing with bankruptcy cases….

However, in some parts of China, such as Shenzhen, there has been more experience with bankruptcy matters because Shenzhen had established a bankruptcy court and insolvency legislation since 1994.[36] In any event, it has been widely recognised that efforts will need to be made to further strengthen judicial expertise in the handling of insolvency cases in China.[37]

Extra-territoriality principle

The Law also adopts an *extra-territoriality principle* in Article 5 which applies the law to a debtor's property located outside the PRC, as well as setting up a procedure for the handling of claims made by foreign insolvency administrators against property located within China's territorial boundaries. See further Chapter 17. This is likely to become an increasingly

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[31] See further Part 5.3A of the Corporations Act 2001 (Aust) for the provisions regarding the Deed of Company Arrangement procedure; For an overview of this procedure see: Murray (2005).

[32] See further, Song (2006).

[33] See generally, Liebman (2008).

[34] For an insider's review by a member of the Supreme People's Court of China of the development of the Chinese court system and its response to economic development see: Xi Xiaoming, (2006).

[35] Li (2004).

[36] See further, Zhang and Booth (2001). Also see Tomasic and Little (1997), pp. 32-33 and 41-43.

[37] See further: Wang (2001).

important principle given the internationalisation of business transactions affecting China. It is however a principle that will depend heavily upon the quality and experience of Chinese judges, or in the absence of that experience, upon the quality of the advice that courts are able to draw upon in making their decisions.

Employee protection principle

Finally, the Law seeks to 'guarantee the legitimate rights and interests of employees of the enterprise' (Article 6). This *employee protection principle* is supplemented by more detailed provisions in later Chapters of the Law setting priorities between various unsecured creditors and giving employee claims a higher priority than normal unsecured claims, such as those of trade creditors.

Additional principles

Chapter 1 of the Law thus sets out ten primary insolvency related principles that are built upon in later provisions of the Law. These additional principles can be implied from the terms and procedures found in subsequent chapters of the Law. For example, the judicialisation principle in Art. 3 is linked to another important principle, namely, the expeditious handling of insolvency proceedings. This may be seen as another important principle.

In addition to the above ten Chapter 1 principles, at least ten further implied principles or objectives can be identified from Chapters 2 to 12 of the 2006 Enterprise Bankruptcy Law. These principles, each of which will be considered further below, are as follows:

1. The expeditious processing of bankruptcy cases
2. The efficient proceedings principle
3. The qualified insolvency administrator principle
4. The creditor participation principle
5. The antecedent transactions principle
6. The priorities principle
7. The shareholder subordination principle
8. The pari passu or equality principle
9. The protection of secured creditors
10. The director liability and the sanctioning of fraud principle

The Law imposes strict time lines for the processing of corporate insolvency applications, as set out in Articles 10 – 14. As effective insolvency proceedings require expeditions handling of insolvency applications, strict time lines are imposed on the court. Thus, in a creditor's bankruptcy petition, the court has 5 days from the date of its receipt of the application to notify the debtor that it has received a bankruptcy application; the debtor has 7 days in which to object and if an objection is made, the Court then has a 10 days in which to decide whether or not to accept the application. In the case of a debtor's petition, the court normally has 15 days in which to decide whether to accept a bankruptcy application, although in 'special circumstances', this period may be extended for a further 15 days (Art. 10). Once an application has been accepted by the Court, it has a further 25 days in which to notify known creditors and to announce its decision (Art. 14). A concern for 'timeliness' is found in other parts of the Enterprise Bankruptcy Law, such as in Article 69 (concerned with creditors' committees) and in Article 111 (concerned with the realisation and distribution of assets).

The efficient proceedings principle

A related principle is that after the commencement of insolvency proceedings, the insolvency administrator should be able to undertake his or her responsibilities without time-consuming distractions. For this reason, it is common to impose a moratorium or constraint on other legal proceedings during the course of the insolvency administration. This philosophy is in part reflected in Article 20 which suspend existing civil actions or arbitrations involving the debtor company, and in Article 21 which limits new civil proceedings against the debtor unless these are filed with the court that has accepted the bankruptcy application. But, these provisions fall short of providing a full moratorium on legal proceedings during the course of the insolvency administration.

The qualified insolvency administrator principle

Effective insolvency proceedings depend upon the availability of suitably qualified insolvency practitioners to assist the court in the handling of cases that have been accepted by the courts. It will be difficult for China to build a corps of qualified insolvency practitioners over night; unfortunately, these did not emerge under the 1986 Bankruptcy Law; as Professor Li observed in 2004:[38]

> Professional services for handling bankruptcy cases are uncommon and rudimentary in China. The majority of Chinese liquidation professionals lack experience in handling complicated bankruptcies, resulting in low efficiency and high cost for their work. Only a few law firms and accounting firms have been involved in bankruptcy cases. Moreover, there is no trustee system for handling bankruptcies.

Thus, Article 13 provides that once the court has accepted a bankruptcy application it is required to 'designate an administrator' to manage the insolvency administration. The administrator is required to perform their duties in accordance with the Law and is obliged to report to the Court and be subject to the supervision of the creditor' committee (Art. 23). Usually that person will be drawn from a government department or from a law firm, a certified public accountancy firm or from a bankruptcy liquidation firm. Although the administrator has very wide duties in an insolvency, the Enterprise Bankruptcy Act itself does not lay down any detailed rules in regard to the qualifications of such a person, apart from excluding various categories of persons from being appointed as an insolvency administrator, such as a person with a criminal record, a person whose professional qualifications have been revoked, a person with an interest in the case or such person that the court may deem it to be improper to appoint (Art. 24). However, the Supreme People's Court Regulations, which are discussed in Chapter 6, do set out more detailed rules in regard to this important matter.

The creditor participation principle

Another important principle that is reflected in corporate insolvency statutes is the principle that creditors should be given an opportunity to participate in the insolvency proceedings. This principle is important as insolvency proceedings are usually brought by creditors and they naturally have a significant interest in the manner in which the administration of the insolvency is conducted. This principle is expressed in a number of ways in the PRC Enterprise Bankruptcy Law, such as in the procedure allowing creditors to prove their debts (Art. 49); also, the provision for the holding of meetings of creditors gives a wide range of

[38] Li (2004).

functions and powers to creditors, including the supervision of the administrator and voting on and adopting plans made by the administrator (Art. 61).

Creditors' meetings can potentially play an important role in insolvency administration as the resolutions passed by these meetings are binding on all creditors (Art. 64). Furthermore, a creditors committee may be established and given a wide range of functions, such as those set out in Art. 68; these include the supervision of the management and disposition of the debtor's property and the supervision of the distribution of this property. The administrator is required to report to the creditors' committee and Article 69 requires that this be done in a timely manner. In the absence of a creditors' committee, the administrator is required to report to the People's Court (Art. 69). In practice, although there are good theoretical reasons why creditors should participate in insolvency procedures[39], in reality they do not do so very much in China or Hong Kong.[40]

The antecedent transactions principle

It is common for corporate insolvency statutes to have specific rules for the handling of antecedent transactions which are deemed to have been entered into to avoid the effects of later bankruptcy proceedings. Thus, Art. 31 gives the administrator the right to request the court to nullify certain questionable transactions that were entered into in the twelve months prior to the court's acceptance of the bankruptcy application. See further Chapter 8 where these laws are discussed. This important principle could be linked to the last two principles, the director liability principle and the principle regarding the handling of fraudulent actions.

The priorities principle

In any insolvency there will be a variety of claims made against the debtor's property. It is therefore necessary to have a priorities regime that ranks different claims by class. This principle is reflected in Articles 41 to 43 which list the order in which debts are to be paid. Firstly, the costs of the insolvency proceedings, including the expenses of the insolvency administrator , have priority and may be paid at any time (Arts 41 and 43); secondly, priority is given to the payment of all expenses and debts incurred 'for the common good of creditors' (Arts 42 and 43).

In a bankruptcy liquidation, similar priorities are set out in Article 113. Thus, after the payment of the expenses of the bankruptcy and debts incurred for the common good of creditors, the priority order in which bankrupt property is to be distributed, as set by Article 113, is firstly, the payment of wages and related employee expenses; secondly, social insurance premiums that the bankrupt enterprise has failed to pay, and finally, 'common bankruptcy claims.' The concern for the interests of employees of bankrupt enterprises has been an important issue in the internal Chinese debates leading up to the passage of the Enterprise Bankruptcy Law.[41] A sense of these debates concerning the priorities of employees in an insolvency can be gained from the following passage from a paper prepared Li Guoqiang, a senior officer of the State Council's Development Research Centre:[42]

> There are a number of arguments that support the priority of workers' claims; it is people oriented; it conforms to the spirit of the Constitution; failure to pay wages

[39] Tomasic (2006).
[40] Tang (2006).
[41] See further, Wang (2006).
[42] Li (2006).

> and social security premiums due violates laws such as the Labour Law; it does not conflict with Security Law; it supports social stability; and banks are more capable of identifying and bearing risks than workers. At the same time, there are arguments against the priority of workers' claims: wages and social security premiums in arrears should be regulated in accordance with the Labour Law; the Bankruptcy Law can not violate the principle of priority of security interests; some enterprises are more likely to infringe upon the rights and interests of workers; banks will be forced to increase interest rates and will be reluctant to lend, resulting in an eventual loss of employment opportunities; and workers' priority will cause an increase in bad loans and, in turn, increase financial risks. The essence of the controversy is how to balance the interest relation among creditors based on the national conditions of China in order to properly protect the rights and interests of creditors, and to establish and develop an efficient and fiduciary economic order.

The shareholder subordination principle

A basic principle of company law is that the company is a separate legal person and therefore that the liability of shareholders is limited to any amount that remains unpaid on their shares. This is impliedly recognised by Article 35 of the Enterprise Bankruptcy Law which allows the administrator to make calls upon shareholders to contribute any remaining capital contribution that they have agreed to make to the company. In a liquidation of a company the shareholders would normally stand in line after the unsecured creditors. It is commonly accepted that shareholders would be entitled to receive any residue that remained after the payment of the costs of the insolvency and of claims by secured and unsecured creditors.

This principle does not seem to be directly recognised by the Enterprise Bankruptcy Act as Article 118 contemplates that any residual assets would only be distributed to creditors. This may need to be clarified so as to confirm the well established principle that shareholders are not liable for any debts of the company and that they are entitled to any residue that may remain after the distribution of assets to creditors.[43] There may also be situations where a shareholder might be allowed to claim as a creditor if they can show that they invested in the company upon the basis of misleading information provided by the company.[44] In the context of a reorganisation under Chapter 8 of the Law, shareholders are prohibited by Article 77 from claiming a distribution of any profits from their investment in the company.

The pari passu or equality principle

Professor Goode has suggested in his ninth principle that 'unsecured creditors rank pari passu'.[45] The pari passu principle provides that where there are insufficient assets to pay all of the debts of a particular class of creditors, then each creditor in that class is to be paid equally in proportion to the level of their debt. Thus, Art. 43 refers to the payment on a 'pro rata basis' of the debts of the insolvency proceedings and incurred for the common good of creditors. Earlier, we saw that Art. 6 in the General Provisions in Chapter 1 also provided for the protection of the legitimate rights and interests of employees. The pari passu principle is also reflected in Art 113 which deals with the payment of priorities in the liquidation of a

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[43] This principle can be traced back at least to the celebrated decision of *Salomon v Salomon & Co* [1897] AC 22. Professor Goode (2005), pp. 79-81, also discusses this principle.

[44] See for example, Hargovan and Harris (2007); also see Hargovan and Harris (2006).

[45] Goode (2007), p. 77.

bankrupt enterprise. Where the assets are not sufficient to satisfy all demands, they are to be distributed amongst members of the group of creditors on 'a pro rata basis'. In practice, the pari passu principle is more often offended against than complied with in many insolvency rules. This is because statutory priorities for employee claims, for example, operate to undermine this principle. The principle is also to be balanced against other principles, such as freedom of contract, which allows a debtor to give advantages to particular creditors, such as by providing security for the debt.[46]

The protection of secured creditors

The protection of secured creditors is widely regarded as a basic insolvency principle. Professor Goode list this as the third in his list of insolvency objectives and the UNCITRAL Legislative Guide lists as its eighth objective 'the recognition of existing creditor rights and establishment of clear rules for ranking of priority claims'. There has been a heated academic debate about the alleged unfair advantages enjoyed by secured creditors over other creditors, especially involuntary creditors. This debate is well described in the UNCITRAL Legislative Guide and space prevents a further review of it here. Whilst it is true that the well advised lender will ensure that they obtain some security over an asset of the debtor, other creditors are not in as advantageous a position. Nevertheless, the importance of the protection of secured creditors has been recognised in the 2006 Law.

In the situation of a reorganization under the 2006 Enterprise Bankruptcy Act, during the reorganisation period, Article 75 provides that secured creditors are prevented from being able to exercise their legal rights as secured creditors; however, secured creditors are permitted to apply to the court to be allowed to exercise their rights if they can show that a 'marked depreciation of value of the security' may arise. Any draft reorganisation plan must classify creditor claims into different classes (Art. 81). Where meetings of creditors are to be held to consider a draft reorganisation plan, Article 82 requires that separate meetings of secured creditors must be organised. In regard to a compromise under Chapter IX, secured creditors may exercise their rights as secured creditors as soon as the court has approved a proposed compromise (Art. 96). Finally, in a bankruptcy liquidation, Article 109 proclaims that a 'creditor secured by the specific property of the bankrupt shall enjoy the priority in being repaid with the specific property.' Where the security is insufficient to repay the amount that is owed as a secured creditor, that creditor must then claim any remaining amount due to them as if they were an unsecured creditor.

The director liability and sanctioning of fraudulent actions principle

Insolvency laws have long contained provisions which are aimed at attaching liability to the former controllers of a company who may have acted illegally and who might be able to contribute to the pool of funds available for distribution by the administrator. Although this is categorised as an implied principle, it is of such importance that evidence of it can also be found in the General provisions in Chapter 1; thus, Article 6 states that the people's court which accepts a bankruptcy case may also 'investigate the business managers of the bankruptcy enterprise for their legal obligations.' Article 125 of the Law creates a civil liability for a director, supervisor or senior manager of the bankrupt enterprise who failed to comply with his or her legal obligations and failed 'to be honest and hardworking' and where this conduct 'leads to bankruptcy of the enterprise.' This article also disqualifies a director, who is found to have breached this provision, from serving as a director, supervisor or senior

[46] It is beyond our scope here to provide a detailed discussion of the pari passu principle, but the interested reader is referred to the lengthy discussion of this matter in the UNCITRAL Legislative Guide, pp 116-161.

manager of any enterprise during the three after the termination of the bankruptcy. This provision may be compared with other insolvent trading provisions found in other countries.[47] See further Chapter 14.

The Enterprise Bankruptcy Act also contains a series of sanctions to ensure that certain key principles are complied with. As we have seen, Article 6 provides that when the court hears a bankruptcy matter, it is obliged to investigate whether any managers of the business acted in breach of their legal liabilities. As a means to ensure an effective bankruptcy administration, various persons are prohibited from serving as a bankruptcy administrator (Art. 24); this includes persons convicted of an offence, persons whose qualification certificate has been revoked, persons with a conflict of interest and such persons as may be deemed by the court to be improperly appointed.. The Law also declares certain actions to be void; these include the concealment or transfer of property to avoid the repayment of debts and the fabrication of debts (Art. 33). Probably the most important liability provision is found in Article 125 which, in part, states that:

> Where a director, supervisor or senior manager, going against his obligations, fails to be honest and hardworking, which leads to bankruptcy of the enterprise where he works, he shall bear civil liability according to law.

What is missing in these provisions in a suitable insolvent trading provision which holds directors to be personally liable if they consciously allow the company to trade even though they know that it will not be able to pay its debts when they fall due. Such mechanism are an import trigger to ensure that directors do not allow insolvent enterprises to continue to trade to the detriment of creditors.[48] Without such sanctions as these, it is likely to be difficult to find evidence to that connects the dishonest and the bankruptcy of the enterprise so as to satisfy the requirements of Article 125. An insolvency administrator should also be able to bring proceedings against former directors of an insolvent company where it can be shown that they failed in their duty of care and diligence towards the company. Perhaps this may be implied from the use of the phrase 'honest and hardworking' in Article 125. At the very least, this should imply a disqualification regime for incompetent or careless directors. A more detailed director disqualification regime is therefore essential if this principle is to be made effective. The legal responsibilities provisions in Chapter 12 of the PRC Companies Law of 2005 also do not impose personal liabilities upon directors of failed companies; instead, their principal focus is upon the failures of companies and not of their directors. However, Article 148 of the Companies Law states that directors and senior managers have "duties of loyalty and diligence to the company" whilst Article 149(8) proscribes acts of directors that are committed in breach of the "duty of loyalty to the company." Moreover, Article 150 does provide an important avenue for actions for damages being taken against corporate officers when it states that:

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[47] See the insolvent trading provisions in s 588G of the Australian Corporations Act 2001 and the provisions in ss 216 and 217, Insolvency Act 1986 dealing with the use of phoenix companies by directors or shadow directors in the UK. Both the Australian and UK provisions impose a personal liability upon directors of insolvent companies who have breached these provisions. The UK Insolvency Act 2006 also prohibits 'fraudulent trading' (in s 213) as well as the more useful prohibition of 'wrongful trading' on the part of directors (in s 214) making them personally liable for their actions leading up to the liquidation of the company.

[48] Examples of such provisions might include the 'fraudulent trading' provisions found in s 993 of the UK Companies Act 2006; the 'wrongful trading' provisions found in s 214 of the UK Insolvency Act 2006; and the insolvent trading provisions found in s 588G of the Australian Corporations Act 2001.

> "Where a director, supervisor or senior manager violates laws, administrative regulations or the company's articles of association in performance of his duties for the company, and thus causes losses to the company, he shall be liable for compensation."

There is however a need for further refinement of legal rules in regard to directors' duties in the context of insolvent corporate enterprises in China.[49]

Conclusions

Efforts to distil principles or objectives from legislative instruments such as the PRC's 2006 Enterprise Bankruptcy Law are to some degree impressionistic. Given the drafting style adopted, the language of the statute is sometime opaque and as such it will be left to the Supreme People's Court to issue more detailed guidelines or instructions as to how to interpret this new law.[50] It may be that more principles or objectives are read into the Law or that some 'principles' identified here are reduced to being nothing more that flexible norms or expectations.

Moreover, some principles may well sound impressive when read in the statute, but what will be more important will be how these principles are implemented; this will determine the real meaning and significance of these principles. Furthermore, the nature of enforcement actions that may be taken to enforce the principles that are evident from a reading of the Law, will be important in settling the importance of each of these various principles.

All of this may take some time to accomplish and as such this chapter is only the start of a journey of discovery and not the end of the road. However, the enactment of the legislation is an important landmark on this road. It may well be a long journey before the full significance of the new law is both understood and accepted in China.

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[49] See further for a discussion of these corporate governance issues: Feinerman (2008) pp 46-57.

[50] See for example the Regulations discussed in Chapter 6 of this volume

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